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APPRAISAL STAGE

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Operation Name	First Programmatic Sustained Growth and Income Convergence DPL
Region	Latin America and Caribbean
Country	Colombia
Sector	General finance sector (25%); General education sector (20%); Public administration- Industry and trade (15%);Central government administration (40%)
Operation ID	P149609
Lending Instrument	Development Policy Lending
Borrower(s)	COLOMBIA MINISTRY OF FINANCE
Implementing Agency	
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Corporate Review Decision	TBD

I. Country and Sector Background

Colombia's strong economic performance has contributed to poverty reduction and shared prosperity in the last decade. According to Colombia's official poverty line[1] poverty rates decreased significantly in the last decade (from 49.7 to 30.6 percent between 2002 and 2013). Poverty reduction has been accompanied by progress in shared prosperity, with the income growth of the bottom 40 percent of the population reaching 7.9 percent over the period 2008-2012 compared to 5.2 percent for the total population. These trends are mostly explained by sustained economic growth. More than 60 percent of the poverty reduction over the last decade is explained by income growth and labor market participation. The unemployment rate fell (from 15.6 percent in 2002 to 9.6 percent in 2013) while the overall participation rate increased (from 62.3 to 64.2 percent in the same period), but Colombia's labor market outcomes remain much worse than the LAC average (6.5 percent unemployment and 71 percent participation rate).

Colombia has consolidated its position among the top performers in Latin America (LAC), helped by macro stability reforms and a favorable external environment. Colombia's sound macroeconomic management, based on a combination of its inflation targeting regime, floating exchange rate, and a strong track record of fiscal reforms, has helped the country weather the global financial crisis and sustain relatively high growth rates in its wake. Colombia's performance has also benefited from a favorable external environment. The country received large capital inflows, taking advantage of abundant

[1] Which is nearly four times the Bank's benchmark poverty line of $1.25 /day.

international liquidity. High commodity prices contributed to an expansion of extractive industries production and exports as well as fiscal revenues, having important implications for growth. Colombia had an average growth rate of 5.4 percent prior to the global crisis (2004-08) and during recovery (2010-11), helping close the country's per capita income gap with top LAC economies and high income (OECD) countries. However, growth slowed down in the last two years as the external environment started to change.

Going forward, Colombia will have to rely on its ability to address structural bottlenecks in order to sustain high growth, speed up convergence in standards of living. Favorable external conditions, i.e. "tailwinds", are expected to recede. As international investment conditions deteriorate and commodity prices stagnate, economic growth will depend more on Colombian firms' ability to effectively produce and sell goods and services. In this context, addressing structural bottlenecks to economic growth will yield important dividends. In particular, closing Colombia's gap with top performers in the LAC region and OECD with respect to physical capital, labor and human capital standards, as well as productivity, particularly innovation and regulatory environment for business, would help sustain the high levels of growth, poverty reduction and shared prosperity enjoyed over the last decade. It would also continue promoting a convergence in living standards between Colombia and this set of countries.

Colombia faces a number of structural bottlenecks limiting Colombia's long term growth performance. Bottlenecks include financial markets development (in particular financing for investment in infrastructure and physical capital by firms), low levels of human capital and skill mismatches, limited innovation, restrictive business and labor regulations, limited international trade, and impacts of the armed conflict.[2] In most of these areas, Colombia presents a significant performance gap with respect to top LAC economies and OECD countries. Addressing those gaps is critical to sustain high growth rates, continue social gains and speed up convergence in standards of living.

II. Operation Objectives

The first programmatic sustained growth and income convergence development policy loan (DPL) supports the Colombian government's efforts to sustain long-term growth and increase productivity. The DPL is the first in a series of two single tranche operations supporting a program of structural reforms to promote long term growth. The program seeks to address key structural bottlenecks to growth and convergence, and help close productivity and efficiency gaps with higher income countries. For this purposed the supported program addresses issues such as access to financing for investment in infrastructure and physical capital by firms, human capital accumulation and skill mismatches, limited innovation and managerial expertise in private firms, and the need for trade facilitation.[3] Thus, the program development objective is to promote growth and income convergence with top LAC and OECD countries by fostering solution to close gaps in infrastructure and firm financing, improving quality and allocation of productive skills and increasing productivity through innovation and efficiency business regulations.

[2] OECD Colombia Economic Survey (2013)
[3] Colombia Growth and Structural Changes Policy Note, 2014

The Programmatic Sustained Growth and Income Convergence Development Policy Loans contribute to Colombia's growth and convergence agenda by supporting the implementation of policy reforms in three main areas: (Pillar 1) fostering solutions to develop infrastructure financing and increasing access to finance for firms; (Pillar 2) improving the quality and allocation of productive skills; (Pillar 3) increasing productivity by promoting innovation and an efficient regulatory environment. The policy areas supported by this first DPL and the prior actions under each pillar are described in the table below:

Objective	Prior Actions under DPL1
Pillar 1-- Fostering solutions to develop infrastructure financing and increasing access to finance for firms	
Fostering the financing of key transport infrastructure under the government's 4G projects.	**Prior action #1**The GoC has revised the regulatory framework relating to individual credit limits and investment regimes of credit institutions, to allow for additional investments in the 4G projects (Decree #816, April 2014)
Improving access to credit by firms	**Prior action #2:** The GoC has improved access to credit by regulating the use of movable assets as collateral in financial operations. (Ley de Garantias#1676,August, 2013; Decree 400, February 2014)
	Prior action #3 - The GoC fostered capital market developments by: i) creating an alternative issuance scheme (*Segundo Mercado* that grant access to capital markets to a more diversified group of issuers and ii) supporting the diversification of institutional investor base through lower entry barriers (Decree #1019, May 2014, drafted but not approved, expected by July, 2014; Decree 1242/June 2013; Decree 1243/June 2013)
Pillar 2-- Improving the quality and allocation of productive skills	
Improving the matching between jobs and skills	**Prior action #4** The GoC has integrated at the Ministry of Labor the design and implementation of the Public Employment Service (PES), supported on an upgraded registry for unemployment and a unified national system for matching workers and vacancies. (Law 1636, July 2013; Decree 2521/2013, Decree 2852/2013, Decree 722, April 2014)
Building professional skills	**Prior action #5** The GoC has strengthening professional training and skill formation by i) promoting strategic professional training to unemployed individuals in line with firm's demands; and ii) regulating the provision and financing of continued professional training, and creating incentives for firms to invest in training (improving firms' management of human capital) (Decree 681/2014, Decree 2852/2013)

Pillar 3—Promoting Innovation and Improving Business Regulations	
Promoting innovation and technological progress	**Prior action #6** The GoC has strenghthened its system of tax credits for innovation, science and technology by: i) clearly defining the roles and responsibilities of the National Council of Tax Credits for innovation; ii) clearly defining expenditures eligible for tax credits as well as monitoring and evaluation. (Decree 121/2014, Agreement 09, approved in July 31, 2014)
Improving regulatory efficiency	**Prior action #7** The GoC has approved a CONPES defining the new policy for production of regulations, which implements evaluations of economic and social impacts and efficiency of policy reforms. The policy, which is in line with OECD best practices seeks to reduce distortions and inefficiencies from regulatory changes. (CONPES #, pending approval, expected September 2014)
Streamlining customs procedures	**Prior action #8** The GoC has issued the decree which constitutes the legal base for restructuring the National Tax and Customs Administration, with the purpose of streamlining processes and improving efficiency and effectiveness**.** (Decree #, approval expected in September 2014)**)**

III. Rationale for Bank Involvement

The proposed operation is fully aligned with the Colombia National Development Plan and the Colombia Country Partnership Strategy (CPS). The operation has been requested by the Colombian government and underscores the government's continued interest in engaging with the World Bank to strengthen economic activity and shared prosperity. In particular this operation is consistent with the World Bank FY12-FY16 CPS strategy on the pillar of inclusive growth with enhanced productivity, and with the government's 2010-2014 National Development Plan, in particular the pillar of sustainable growth and productivity.

This DPL also complements the Bank's long-term partnership with the GoC to support the country's development and contributes to the WB twin goals of reduced poverty and shared prosperity. This DPL has been supported by the technical work developed under different thematic Programmatic Approach (PA) for Colombia, including the Sound Financial Sector Development PA, the Innovation and Competitiveness PA and the Public Sector PA. In addition, the definition of the PDO and the overall diagnostic that supported the design of the operation were based on the work under the Strengthening Fiscal Policy for Sustained and Inclusive Growth PA and the Colombia Policy Notes. Finally, it is worth highlighting that this DPL series follows a long engagement with Colombia through DPLs, including the Fiscal Sustainability and Growth Resilience DPL I (2011) and II (2012) and the Fiscal Policy for Shared Prosperity DPL (2013) and the DPL series on business productivity and efficiency implemented between 2006 and 2011.

IV. Tentative financing

Source:		($m.)
Borrower		0
International Bank for Reconstruction and Development		400
Borrower/Recipient		
IBRD		
Others (specifiy)		
	Total	400

V. Tranches

The US$400 million DPL will be disbursed once the operation goes into effect and is contingent upon the Government's completion of prior policy actions.

VI. Institutional and Implementation Arrangements

The preparation of this operation is being led by the Ministry of Finance and the National Planning Department, with participation from the Ministry of Education, Ministry of Labor, Ministry of Commerce, DIAN, and SENA. These agencies will be responsible for the overall implementation of the proposed operation, and for reporting on progress.

The Program outcomes will be monitored through the measurement of the indicators included in the policy matrix. The indicators seek to assess progress towards the implementation of the reforms supported by the proposed DPL and will be evaluated one year following the disbursement of the Loan.

VII. Risks and Risk Mitigation

The overall risk for this operation is moderate. The main risks arise from changes in the external economic environment, such as stagnation of oil prices and variation in external financing conditions. The team believes that the program supported by this DPL will help strengthen the domestic economy and help attenuate the impact from larger than expected external shocks.

Economic Risks

Colombia is exposed to two main types of external shocks: a decline in oil and mining prices and financial turmoil's associated with a possible tapering of US monetary policy. This risk is mitigated by the fact that the country's macro resilience is based on solid initial conditions and policy buffers to respond. In addition, structural reforms supported by this operation will contribute to growth and partially compensate for adverse changes in the external environment. The absence of significant domestic or external imbalances helps shore up stability. Prudent fiscal and monetary management – with room for countercyclical policy responses, substantial foreign direct investment inflows, comfortable levels of foreign reserves, and a Flexible Credit Line with the IMF help protect Colombia's external position.

The appreciation of the Colombia peso, which has been an issue of concern, has halted since 2013. The Colombian peso (the nominal as well as the real effective rate) has grown gradually stronger in recent years because of significant capital inflows (primarily FDI) and improved fiscal policy. Recently, however, a combination of lower interest rates, currency purchases by the Central Bank, and change in the international financial environment have contributed to a nominal depreciation of the peso during 2013, and a relatively stable position during 2014. This helped alleviate Dutch disease concerns.

Implementation Risks

While direct risks associated with the implementation of the prior actions are low, indirect risk might affect the ability of reaching desired results in some cases. For example, instruments to help financing infrastructure projects (supported under prior action one) will only be effective if these projects are well-executed. The government has made important regulatory changes to help mitigate risks associated with implementing infrastructure projects, but Colombia's track record suggests that delays and interruptions could arise. In addition, as raised in the environmental assessment, it is possible that these projects end up having indirect adverse environmental impacts if environmental regulations and consultation processes are not enforced well.

VIII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The Government policies supported in this DPL are expected to have a positive poverty and social impact. Income growth and labor markets outcomes help explain 60 percent of Colombia's poverty reduction in the last decade. The actions supported by this operation intended to further increase growth and productivity and likely to have similar impacts on poverty reduction and share prosperity. The Poverty and Social Impact Assessment has been carried out, documenting these expected positive impacts from a social, gender and distributional perspective. This assessment, explains the potential positive outcomes of these Policy Actions on overall growth, employment and welfare of the poor and those in the bottom 40 percent of the income distribution.

The PSIA is structured to follow the policy areas outlined under the Proposed Operation. Specifically, within Pillar I, policies that support infrastructure financing and increase access to credit are expected to have a positive impact, by increasing employment (and formalization), reducing consumer prices (lower costs of transport and logistics), and smoothing consumption of the poorest households. In terms of Pillar II, the recently implemented system for matching workers and vacancies is expected to increase the employability of the bottom 40 percent since they rely more on these services rather than their own networks to find a job. Moreover, strengthening the professional training system targeted to the unemployed is expected to increase the probability of employment of the poorest. Within Pillar III, tax credits for innovation will likely increase formalization and earnings in those economic sectors where the funds will be allocated and reduce entry barriers for firms. Moreover, the prior actions regarding trade facilitation will likely cut costs of logistics and increase access to market and affordable goods.

Environment Aspects

Colombia has a fairly robust environmental policy framework that is expected to be effective at mitigating possible adverse impacts of investment growth supported by the DPL. Colombia has a comprehensive system of environmental licensing dating back to the 1974 Code on Renewable Natural Resources and Environmental Protection. The requirement to carry out environmental assessment for projects with possible adverse environmental impacts in its current form in Colombia is regulated by the Law 99 adopted in 1993 and series of subsequent modifications. As stipulated by the law, the Ministry of Environment and Sustainable Development (MADS), the regional environmental authorities (CARs) and municipalities, depending on the nature of the works, are responsible for issuing environmental licenses. However, the enforcement and compliance monitoring capacity varies by region and by municipality and in some cases requires strengthening.

An environmental assessment is being prepared to address possible environmental risks. The environmental assessment is being carried out to evaluate the likelihood and the types of adverse environmental impacts that could result indirectly through the support of policy measures to improve infrastructure financing for 4G projects(prior action 1). The assessment will include an analysis of the types of projects that are expected to be implemented as part of the 4G program, the possible environmental risks and mitigation measures, as well as the extent to which the existing regulatory framework (supported by the Sustainable Cities DPL) is sufficient in addressing the environmental risks. The environmental assessment will discuss the overall institutional capacity of the agencies responsible for enforcing the applicable environmental regulations and issuing licenses and ally assess the quality of monitoring and enforcement. The environmental assessment and licensing process is also expected to help screen out the projects with possible significant adverse impacts to a large extent and design mitigation measures in the case of possible impacts.

IX. Contact point

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